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Dow Theory Letters

"The Market as Interpreted under the Dow Theory"

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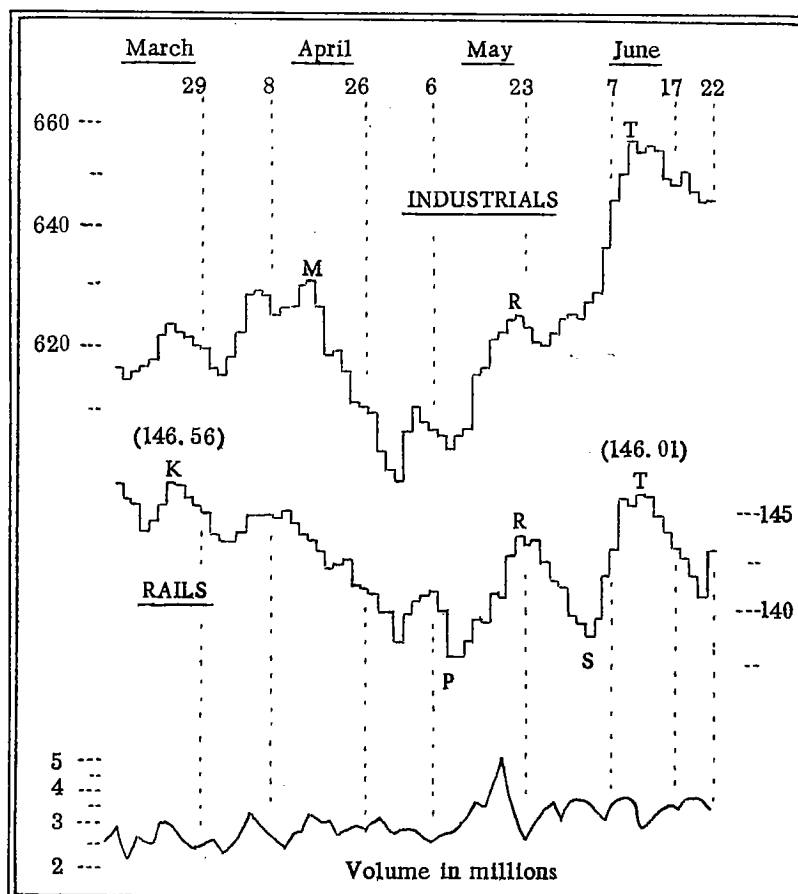
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"One of the shortest ways of going wrong," wrote Hamilton, "is to accept an indication by one Average which has not been clearly confirmed by the other." A study of the history of the price movements shows that many reversals have occurred where one Average would not follow the other (confirm) through a previous point. We have seen a very recent example of this. At point P Rails established a new bear market low (137.68), but when Industrials would not confirm the penetration, the rally to T followed. Now we have another situation wherein confirmation is lacking. The Industrial advance above M (to T) was not confirmed by a comparable Rail move through K (146.56). Unless Rails can confirm the Industrial move, the recent action cannot be considered as having any particular validity.

Starting with the March 16 peak, there have been five Rail attacks on the 146.56 level, but on each rally selling overcame buying and the carriers fell back. A series of descending zig-zags appeared in the Rail Average with a new low recorded at P. At S (138.87) the declining Rail Average held above a preceding low for the first time, following which an ascending zig-zag (P-R-S-T) was formed. Although this gave encouragement to Rail enthusiasts, the Rail group nevertheless failed again on its most recent attempt to better the 146.56 secondary high point. At T, in fact, we witnessed the dramatic picture of Rails actually hurdling the 146.56 point on three intra-day rallies, only to drop lower each time at the close.

A Rail bettering of 146.56 on increasing volume would signify that the secondary trend is bullish in a full Dow Theory sense. Lacking such a confirmation, it seems doubtful that the Industrial rally can progress much further. If Rails violate first S (138.87) then P (137.68) the burden of proof will be thrown completely on Industrials. At that point a series of descending Industrial peaks would appear ominous. If Industrials then penetrate their bear market lows at J (599.10) it will be obvious that the third leg of the bear market is underway.

Many traders will make speculative commitments if Rails penetrate the 146.56 barrier. Those who wish to climb aboard should remember that they are playing against the primary trend, and "stop-loss" orders placed a few points under purchases can provide excellent "insurance" in case of a reversal. Conversely, short sales made in this area should be covered on an upside Rail confirmation.



QUESTION "Could it be that a 'line' was formed in the Averages beginning around early March? Both Averages have held within the 5% limit that you have given for a line formation."

ANSWER. From February 26 to May 5 Industrials fluctuated between 632.00 and 599.10. Buying and selling seemed evenly matched, and the movements of the Industrials were contained within 5% of the price of that Average. Between March 7 and the present, Rail movements have been confined to a range of 8.88 points or a bit over 6%. Normally, price fluctuation within a line area tends to become less pronounced and to provide a picture of equilibrium. Volume within line areas generally grows sluggish. Neither of the latter phenomena occurred during the period in question, so that I am doubtful as to the wisdom of labeling the movements over the last four months a line. There are those who will insist on calling the recent structure a line, however, but this will still not essentially alter the reading of the Averages. Rhea noted that in line formations when a single Average breaks out unaccompanied by the other, more often than not the two Averages will eventually penetrate the line in the opposite direction.

QUESTION. "Suppose Industrials now decline below points H (632.00) and M (630.77), but Rails later confirm the Industrial advance by bettering point K (146.56). Would the Rail confirmation be a valid one?"

ANSWER. Yes, Hamilton discussed a number of such instances. Hamilton did not believe that a time limit should be placed on confirmation -- it can take place in a day, a week or a month. He did, however, feel that the forecasting authority of a confirmation was heightened when the two Averages confirmed on the same day or within a few days of each other. Further authority in confirmation, noted Rhea, was provided when confirmation came in the primary direction on increasing volume.

SHORT INTEREST RATIO A few years ago I spent some time at the record room of the N.Y. Stock Exchange digging out figures on the monthly short interest totals and the monthly average volume of transactions of the Exchange (going back to 1931 when the short interest figures were first released). Dividing the monthly short interest figures by the corresponding average daily volume for each month since 1931 provided a set of seldom seen figures -- the short interest ratio (S.I. ratio) from 1931 to the present. These statistics were entered on charts together with the movements of the D-J Industrials over the same period of time. A study of those charts is most informative.

As previously discussed in these Letters and in Barron's (Barron's -- Sept. 28, 1959), the S.I. ratio generally increases markedly before or during the early part of a sustained upward market swing. When short sellers put out their wares they are speculating on a substantial decline. As a rule, unless the market is subject to real selling pressure (with heavy downside volume) the short sellers will not show profits. When the bears short a primary bull market or a "sold-out" bear market and downside volume is not forthcoming, they are trapped, and they will be forced to cover their shorts. This situation makes for technical strength in the market and is a prerequisite for a sustained rise. For this reason a dull or low-volume market heavily laden with shorts is ready for an advance. The best measure of this type of technical condition is the ratio of the average daily volume to the monthly total short interest or the S.I. ratio.

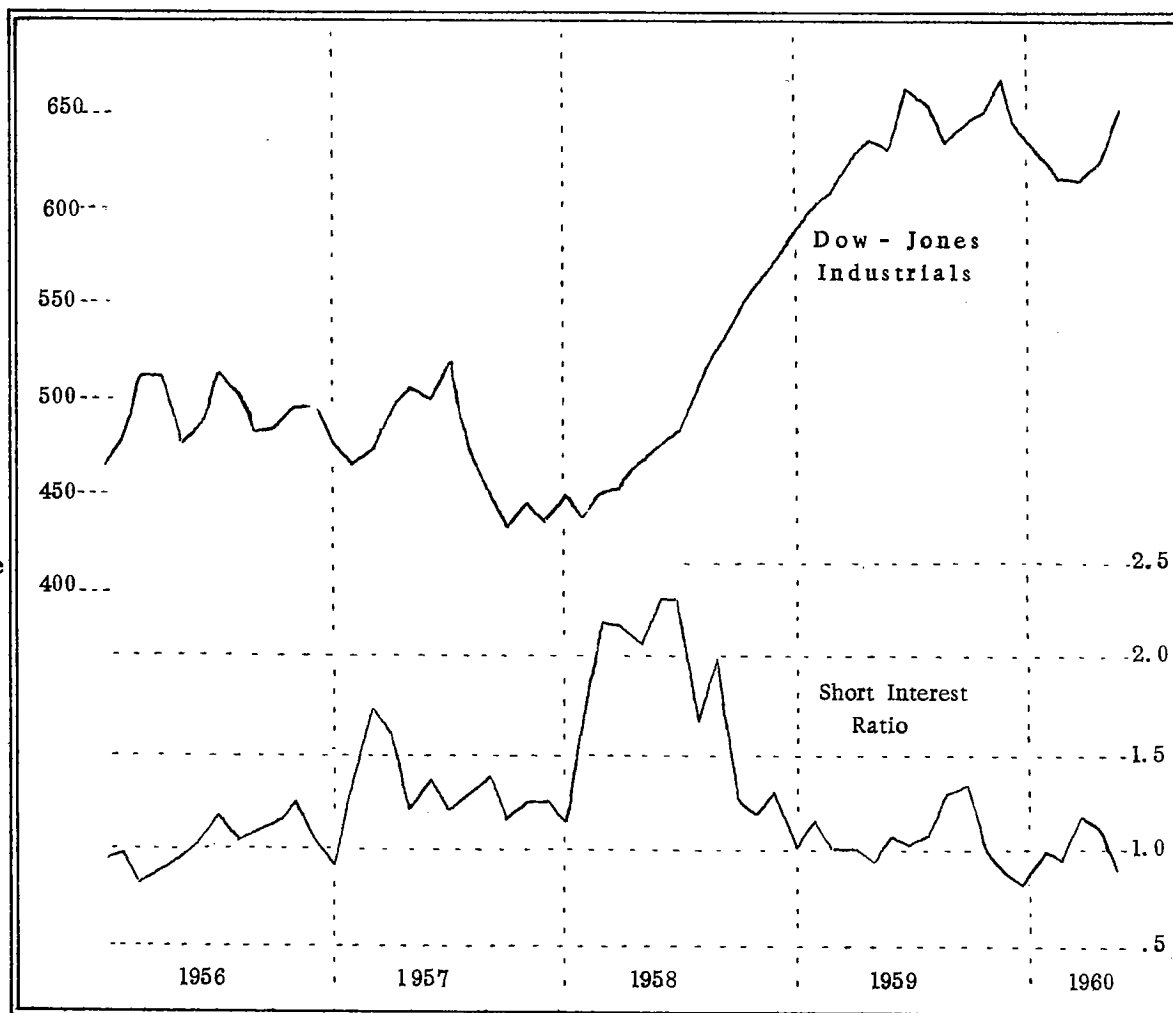
Since 1931 there has not been a single sustained upward movement in stocks without a S.I. ratio of 1.5 or better preceding such a swing. For instance, prior to the historic advances of 1949-53, 1953-56 and 1957-59 the S.I. ratio rose well above 2.0. Note on the chart that even before the "triple top" of July, 1957, the S.I. ratio advanced temporarily to 1.75, and this provided enough technical strength for the Industrial surge to 520.

At the bull market top of July, 1959, the S.I. ratio held in the 1.0 area. This figure was the lowest in over two years but well above the extremely dangerous levels which accompanied the 1937 top (.55) and the 1946 top (.75). Following the Industrial drop to 616.45 in September, 1959, the S.I. ratio climbed to 1.34 in October, 1959, and this preceded the January, 1960, Industrial peak. By that time, however, the S.I. ratio had dropped to a

new low of .82, a figure which provided a warning of the bear signal to come (see Barron's

Subsequent to the bear signal the S.I. ratio rose to a minor high of 1.19 in April, 1960, and this slight build-up preceded the most recent Industrial advance to 656.42 (June 9, 1960). But in May the S.I. ratio dropped to 1.12. The latest (June 15) short interest total is 3.23 million shares, a drop from the May 15 period. When this figure is divided by the average daily volume for the period (3.58 million shares) the result is a further decline in the S.I. ratio to .91.

The minor April (1.19) peak in the S.I. ratio and the subsequent decline to the current .91 figure does not suggest that the technical position of the market will support any broad or sustained rise from this area.



DAMNING THE DOW THEORY. Last week I received a letter from a subscriber who is angry because the Industrials dropped only 16 points after the bear signal and then followed with a secondary reaction. The letter reads as follows:

"By the way, so the record can be kept -- when you gave your famous bear signal early this year I sold the following -

263 shares of Great Western Financial
1300 shares of Dreyfus Fund
100 shares of Keystone S-4

I have before on my own made many classical market mistakes, but never one of such magnitude and cost. Better than that, I never paid to make mistakes before. I may be wrong about this. What do you think?"

This reader complains because the market did not collapse (which would have shown his sales to be beautifully timed). He writes about my "famous bear signal". He further despairs about the "cost" of his mistake. Let me begin by saying that the bear signal did not belong to me, it was given by the Averages. I have, in these Letters, attempted only to interpret the meaning of the Averages, and I cannot guarantee that an 86 point decline will immediately extend to a 200 point decline. Secondly, if this

correspondent purchased his stocks correctly he should have shown excellent profits, even if he sold on the bear signal. Third, there is a world of difference between a "mistake" which "costs" a man further profits and one which produces a loss of capital. Finally, I have stressed the idea of "probability" in these Letters. History shows that in the majority of cases it has not been profitable to hold portfolios after a bear signal. Profits missed on a reaction following a bear signal must be put down as the cost of "insurance" against a possible disaster. In this business one must always deal with probabilities and the odds, not the exceptions.

In discussing the problem of timing Rhea once wrote, "Those who follow Dow's Theory frequently buy at the bottom, but they seldom sell at the top eighth, unless by accident." I have tried to make this series of Letters a discussion of Dow's Theory and its implications, not a "tip sheet" or an advisory service. I did this because I have seen many investors (myself included) aided by studies of Dow's Theories, whereas I know few if any people who have been helped by somebody else's "advice". As far as Dow's Theory is concerned, I have included the following quotes for the benefit of the aforementioned subscriber. All of them appeared in these Letters at or near the two Industrial peaks of August 3, 1959, and January 5, 1960.

Letter 73 -- July 24, 1959 "I have put stop losses under some stocks, and I am willing to get stopped out. I have sold some others as they went into new high ground just to get used to the idea of cash. When the whole country embarks on a flight from cash and amateurs tell me how to make money in stocks, I tend to harbor a growing affection for 'greenbacks'".

Letter 74 -- August 5, 1959 "I will repeat again that the safety factors in this bull market are diminishing. The Industrial Average is now 250 points and 21 months nearer its ultimate top than it was in October, 1957.....I, personally, prefer not to ride to the final top in a fully invested position."

Letter 75 -- August 14, 1959 "It is enough that the Averages have given their warning." "...I have merely lightened an already light position in common stock (I took some 'insurance' last week when the rails turned weak)."

Letter 89 -- January 6, 1960 "At this stage of the bull market and as stocks work higher, vulnerability increases, and it becomes a case of safety of principal vs. speculative fever and progressively riskier profits. Dow's Theory was designed for the investor or trader who has learned to be satisfied with the best and safest part of the swing...."

Letter 90 -- January 13, 1960 "The steel strike has been settled, business is good and the forecasts for 1960 are better than good. Yet the price movement, following the initial surge which accompanied the upward breakout of the 'line' has been anything but impressive."

SUNDRY OBSERVATIONS. During the broad third phase advance of 1957-59, Wall Street and the public scrutinized the recession economy and concluded that the stock market had "taken leave of its senses". The record six million short interest of mid-1958 attested to the almost universal disbelief in the predictive power of a steadily advancing Industrial and Rail Average. It is interesting to note that this situation is now reversed. A glance at Barron's Business Index (see Letter 107) will show that business, following the bear signal, has been contracting. But now, with steel production at around 60% of capacity, the consensus is that the bear signal meant nothing and that the secondary upmove in the Industrials (unconfirmed by Rails) is predicting a big "second-half rise in business". Such is the irony of the market.

"A period of prosperity," wrote Dow in 1901, "always encourages trading. As long as people make money, their tendency is to enlarge commitments. This is true of everybody from banking syndicates to the keeper of a cross-roads' general store. When, on the other hand, ventures cease to be profitable, contraction invariably follows, increasing with the shrinkage which contraction promotes." In view of this statement, it may be noted that the trend of profits in "big industry" is now down. We hear of a "squeeze" among auto dealers (new cars and compacts hurting profit margins). We hear of pressure on steel profit margins, rail profits, oil profits, aluminum profits. In an effort to beat the profit squeeze investors have shifted their interest to the "defensive" stocks and to such groups as photography, electronics and "leisure" stocks.

All this has happened before. On November 18, 1899, seven months after the peak of the 1899 bull market, Dow wrote, "The specialties will undoubtedly remain the leaders in the market. One of the prominent features of the breadth of trading at present is that unlike previous manipulations of stocks, specialties are now used more like barometers to indicate the action that large interests are taking." Dow's warning proved correct. Investors in 1899 were soon to learn that the "specialties" had not taken the place of the "blue-chip" barometers. In early December, one month after Dow's editorial, the market collapsed in a severe panic.

(Written - Thursday, June 23rd, 1 P.M.)